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Preferred surplus

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great importance. It is becoming of increasing consequence to us that Europe remain a good credit risk. One reason, of course, is that we want our present loans paid at maturity. But, broadly speaking, that will unquestionably happen, whatever temporary disturbances arise in Europe. The continuous year-to-year peace and prosperity of Europe are important to us, because we cannot afford to have any interruption occur in the continuous placing of our surplus funds abroad. Upon the new loans (though, in fact, hardly less upon the expenditures of our tourists abroad) the maintenance of our export trade depends. These new loans provide our foreign customers with the dollars necessary to pay for our surpluses of exports over imports.

What, then, will be the effect of the new reparation settlement on these varied interests of a material nature which we have in the stability of Europe? If the con-

ference has a successful termination—and the prestige, experience, and practical sagacity of its members make such an outcome probable—Germany's now indeterminate reparation liability will be definitely fixed to the reasonable satisfaction of all parties concerned, the present foreign control in Germany will probably be relaxed and the framework of a scheme for the future marketing of reparation bonds may perhaps be provided.

Such a series of accomplishments will not only constitute a distinct advance in the formal position of the reparation problem; they will also result in a substantial easing of the tensions which, in some measure, still remain over from the great conflict. In short, we may hope that the new settlement will strengthen the psychological foundations upon which the peace of Europe rests, and will give added vigor to the functioning of a normal economic régime.

Preferred Surplus

By JOHN R. WILDMAN

A RECENT decision in the Wabash case (*Barclay et al v. Wabash Railway Company*), affecting as it does the matter of dividends, again calls attention to the possibility in the future of a change in the cardinal principle which long since has guided accountants in considering the relation of dividends to surplus. The principle is, that dividends are chargeable against surplus only when declared. The decision in question, if affirmed ultimately by the United States Supreme Court, will challenge seriously continued adherence to that principle, in cases where there are preferred shares.

A characteristic of dividends is that they are spontaneous; that they do not accrue like interest, but set up a right to surplus on the part of the holders of shares, only when declared. This principle holds even though shares carry cumulative rights, the

effect of which is to deny to the holders of junior issues any dividends until all accumulations in favor of preferred shareholders have been satisfied.

The courts generally have been disinclined to dictate to directors with respect to dividends, and to leave to their judgment the question of whether or not surplus should be so distributed. Occasionally, accountants have been required to interpret certain passages in certificates of incorporation where dividend provisions seemed to make dividends akin to interest and to decide whether or not surplus should be assigned to shareholders regardless of action by directors. Generally, the prevailing rule has been that no charge against surplus should be made, notwithstanding the existence of a cumulative right, until directors have authorized the charge by declaration of the dividend.

The rights of preferred shareholders whose stock is cumulative with respect to dividends is clear under the foregoing theory. Whether or not there are profits, or surplus available for cash dividends, the annual dividend rate or amount accumulates and must be satisfied before any distributions to junior shareholders may be authorized. This, however, is but a right of priority in dividends, when, as, and if, declared. It is not an assignment of surplus.

If there are profits in a given year, sufficient to liquidate the claims of cumulative preference stockholders as to that year, but a dividend is not declared out of such profits, the claims of these stockholders for the year in question carry over, and the theoretical effect is to have a preferred surplus, although practically no such segregation of surplus is made.

If there are any profits in a given year, and no other disposition of the profits is made, leaving some amount available for dividend declarations in favor of cumulative preferred shareholders, but no such dividends are declared, theoretically, there is a preferred surplus; practically no such interest in surplus is recognized in so far as accounting is concerned. This statement should be modified, perhaps, to the extent of adding that it is customary to note any accumulation of preferred dividend rights at the bottom of balance sheets.

If there are no profits in a given year, or if there have been no profits in any year since inception, the rights of cumulative preferred shareholders carry on. But there can be no interest in surplus, either actual or theoretical, under the latter status; all of which suggests the fallacy of apportioning surplus without action precedent by the directors.

Until recently it has been thought that there was no necessity to consider any rights of non-cumulative preferred shares in profits which might be earned in a given year, but not declared out as divi-

dends. The issuance of shares with non-cumulative preference rights as to dividends doubtless carries with it the implication of intent to compensate those who so furnished capital to the enterprise, at a given rate, in each year, contingent upon the earning of sufficient net profits to justify the disbursement of such compensation, without detriment to the enterprise. But the decision as to whether or not such disbursement may be made, necessarily must rest with those to whom is entrusted the management of the enterprise. Thus, if the decision of the directors is negative, there is a presumption that the disbursement is not warranted.

Any attempt to state the attitude of the courts generally on this point obviously would be imprudent without first having made a careful study of the decided cases, both pro and con, covering the subject. A somewhat cursory review indicates that as yet there has been no decided trend in the opinions. There are, however, enough cases upholding the non-cumulative preferred shareholder in his claim to a right in surplus if profits in a given year are earned but not declared, to merit some serious thought on the part of accountants.

As far back as 1908, a New Jersey court held to the view which favors the non-cumulative preferred shareholder. (*Bassett v. U. S. Cast Iron Pipe and Foundry Co.*, 74 N. J. EQ. 668,670. 70 ATL. 929). Again in 1924, another action against the same corporation served to emphasize this position. (*Day v. U. S. Cast Iron Pipe and Foundry Co.* 97 N. J. EQ. 389). In this case, one John Day, holding shares of non-cumulative preferred stock, sued to enjoin the payment of a dividend to common shareholders on the grounds that the company had earned profits equal to \$6.11 per share to which non-cumulative preferred shareholders were entitled, but which the company had neither declared nor assigned to such stockholders. The court found for Day and held, in effect, that

although directors may withhold profits earned in a given year, dividends to which non-cumulative preferred shareholders are entitled in that year, if not declared, accrue in favor of such shareholders and must be paid before further dividends are declared in favor of junior shareholders. Commenting on this decision, says the *Commercial and Financial Chronicle* (Vol. 119, October 25, 1924, page 1966), "Under the Chancery Court's decision, cumulative and non-cumulative preferred stocks differ only in that the former are entitled to dividends whether earned or not in any particular year."

In further support of the position taken by the court in *Day v. U. S. Cast Iron Pipe and Foundry Co.*, it is reported by the press, that the Wabash Railway Company has cancelled the 5% dividend on class "B" preferred stock, announced for February 6, 1929, because of a recent decision of the United States Circuit Court of Appeals sustaining the action of certain class "A" preferred shareholders. This action was brought by the owners of class "A" non-cumulative stock, John C. Barclay and the Willoughby Company, who claimed that such shareholders were entitled to dividends in years when profits were earned, before any dividends could be paid to holders of junior issues. The plaintiffs were defeated in the lower court, but the decision was reversed on appeal, and now, it is said, will be carried up by dominant interests which are affected by the decision of the Court of Appeals.

The tendency suggested by the foregoing decisions, namely, to recognize the rights in surplus of non-cumulative preferred shareholders, is worthy of serious consideration by certified public accountants. If the tendency develops into a well settled attitude on the part of the courts, it will be important that accountants recognize this attitude in their treatment of surplus. The advocacy of a step as revolutionary as segregating surplus representing earned

but undeclared dividends, applicable to holders of non-cumulative preferred shares, would be premature at this time. The accountant may safely do no less, it seems, than call attention to the situation, where it applies, in the comments of his report. He may need to go so far as to append a foot-note to the balance sheet, in which attention is directed to the matter. Certainly it would be wise to do so in a balance sheet of the Wabash Railway Company.

News Items

WE are pleased to announce that our firm has been registered as qualified auditors under the Hongkong Companies Ordinances, 1911 and 1925. The Hongkong Act, which is modeled somewhat along the lines of the English Companies Act, requires auditors to be registered before they can act officially for companies registered under that act.

Mr. Frederic A. Tilton, our resident partner in Detroit, has been appointed a member of the Industrial Development Committee of the Detroit Board of Commerce. The personnel of this committee is made up of men prominent in industrial and banking circles. The avowed object of the committee is "To foster, encourage, and aid the development of commerce, trade, and industry within the Detroit Metropolitan Area."

Mr. Padon, of our Tulsa office, recently received the C. P. A. certificate from the State of Missouri.

Mr. O. N. Hutchinson, manager of our Charlotte office, has received the C. P. A. certificate of the State of South Carolina.

Mr. G. W. Price, of our Chicago office, is to be congratulated upon his success in passing the C. P. A. examination of the State of Illinois.